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[INSURANCE]

REVIEW OF CRITICAL AREAS WITH REGARD TO INSURANCE LEGISLATION, REGULATION AND SUPERVISION

Establishment of effective insurance regulatory and supervisory systems

Study by the UNCTAD secretariat

CONTENTS

SUMMARY

- When introducing reforms towards establishing insurance markets ruled by market economy principles and functioning under a liberalized environment, effective regulatory and supervisory systems focusing particularly on consumer protection and prudential regulation should be established by law.

- The liberalization process of insurance markets includes:
  - establishment of competition rules and of transparency and information conditions;
  - shift from coordinated or imposed price fixing mechanisms to a system where rates are determined by market forces;
  - lowering of product control;
  - admission of new domestic and often foreign participation in the market, both at direct and reinsurance level.

- The liberalization process changes the nature of the State involvement in insurance from controlling operations to establishing and monitoring market functioning rules, prudential regulations particularly focusing on solvency requirements and consumer protection measures.

- Reasons for regulating and supervising the insurance industry under a liberalized environment include: establishment of sound and stable financial system, protection of consumers, requirements under world trade liberalization, market efficiency, privatization and opening of markets.

- The regulatory and supervisory framework under a liberalized environment may include:

  Admission requirements consisting of:

  - capital requirements, set at a level discouraging entrants of unsound operators and market fragmentation;
  - monitoring of ownership and management;
  - requirements for business/operating plan and estimates, actuarial and auditing reporting;
  - licensing requirements for intermediaries.

  Monitoring of operations consisting of:

  - effective information system (relevant and adequate reporting and accounting practices);
  - financial solvency requirements including continuous capital, solvency, reserving and investment adequacy.

  Supervision of business conduct including monitoring of:

  - underwriting, rating and insurance contract;
  - marketing and intermediaries (including fraud);
  - reinsurance programmes and security;

  Setting up of consumer protection measures such as:

  - public complaints processing, consumer education and information;
  - establishment of guarantee funds to protect consumers interests in case of insolvencies;

- Under a liberalized environment, a supervisory authority should be established with role and powers defined by law. Cooperation between supervisors of different countries may have to be improved and enhanced.

INTRODUCTION

1. Under section B. (Fostering competitive insurance services), paragraph 4, of the recommendations adopted by the Standing Committee on Developing Services Sectors in Developing Countries - Insurance, at its second session, 4 to 8 July 1994, the Standing Committee - Insurance requested "In view of the immediate relevance and recognizing the importance for developing countries and privatizing their insurance markets of establishing effective regulatory and supervisory systems, the UNCTAD secretariat to prepare a study particularly focussing on prudential regulation and insurance consumer protection." The present study has been prepared in response to this specific request. A second note: "Regulation and supervision of insurance operations: analysis of responses to a questionnaire and possible elements for establishing an effective insurance supervisory authority" (UNCTAD/SDD/INS/10) has also been prepared as a background note to provide additional information on the subject.

2. An Expert Group on prudential regulation and supervision of insurance markets in developing countries and countries in transition to market economies (the Expert Group) held in Geneva from 19 to 20 June 1995 under the auspices of UNCTAD reviewed the present documentation and provided a number of inputs, comments and additions to this study.

3. A previous background note entitled "Issues of insurance regulations and supervision relevant for developing countries" (UNCTAD/SDD/INS/6), from which certain parts have been included in the present study, prepared for the second session of the Standing Committee on Insurance, contains additional relevant information particularly regarding the historical development of insurance supervision in several developed countries and monitoring insurance other than by the State.

4. When introducing reforms towards establishing insurance markets ruled by market economy principles and functioning under a liberalized and privatized environment, effective regulatory and supervisory systems focussing particularly on consumer protection should be in place. The intention of the present study is to provide some suggestions and guidance on the establishment of such systems, it is not meant to propose any model scheme or system.

5. The Expert Group particularly emphasized that insurance regulation and supervision in a country should be tailored to local conditions, political and management cultures and outlooks prevailing in that country. Also, regulatory and supervisory frameworks have to be adapted constantly to match changing conditions, perceptions and economic needs. They also need to be fine tuned and improved in regards to accumulated experience.

6. Under a monopolistic, oligopolistic or State controlled system, the State is involved at every level of insurance operations: it approves and mostly fixes rates, terms and conditions of offered products, determines the type of products and the "State Guarantee" serves as a backing for security and solvency of insurance operations. In some instances (most former socialists countries of Eastern Europe) insurance premiums were paid into and claims settled from State budgets.

7. The liberalization process of insurance include the establishment of markets functioning under competition rules, under which no player should acquire a dominate position or impose its own conditions on the rest of the market, transparency and information conditions are reinforced to allow buyers and sellers to make "informed decisions" based on actual market conditions. Under a liberalized insurance market price fixing mechanisms are changed, away from coordinated rates are determined by market forces. The same applies to product design.

8. The change in market structure through privatization and enactment of competition rules allow entrants of new domestic and often foreign participants in the market. Demonopolization of reinsurance operations also allow for new entrants in the market. More generally, when liberalizing the economy, the demand for insurance tend to increase as state/owned manufacturing or services industries are privatized as these entities inclined to self-insure when they were under State ownership.

9. The introduction of market economy principles and liberalization changes the nature of the State involvement in regards to the monitoring of insurance operations. The role of the State in regards to insurance evolves towards establishing market functioning rules, prudential regulations particularly focussing on solvency and consumer protection measures. Also, at least in a first phase, it may have a role in the development of the insurance industry.

10. Reforms towards market economy, liberalization and privatization are expected to promote entrepreneurial freedom, responsibility and accountability, optimize allocation of resources, increase productive efficiency, bring a better match between supply and demand and ultimately better quality services at lower prices. More specific to insurance, the entry of new participants into the market, whether domestic or foreign, the latter either by way of establishment or through cross-border activities (Reinsurance), could induce a more effective working of the mutualization and risk spreading process which constitute the basis of the insurance mechanism. Possibly increased capacity to underwrite local risk could also be obtained.

11. However, under a liberalized environment, competitive pressure may lead some insurers to turn to unsound practices (uneconomic pricing, cash-flow underwriting ...) in order to obtain market shares. Under such context, insolvencies are more likely to happen. Some of the members of the Expert Group expressed the view that under a competitive environment insurance companies should be "allowed to fail" as a sanction for mismanagement. Thus greater consideration should be given to insurance consumer protection measures.

12. Such measures include prudential regulatory aspects as increased standards for capital and solvency requirements, prudent investment and reserving rules. To monitor compliance with set rules, establishment of an effective information system based on clear accounting and reporting rules is of prime importance. Improvement of market transparency and information towards insurance consumers is also essential. To balance the information asymmetry that may exist under insurance contracts, close monitoring of policy wording could be useful. Consumer education and establishment of offices whose duty is to respond to insurance customers complaints are also contributing to protecting insurance consumers. To shield consumers from the consequences of insolvencies, establishment of guarantee funds may be considered. Under a liberalized environment and concomitant lowering of product control, the monitoring of intermediaries (agents, brokers) is also of increased importance. The opening to foreign participation into the domestic market both at the direct level or through reinsurance poses questions in terms of consumer protection especially in regards to the form of participation and security assessment.

13. Liberalization of an insurance market should not be considered as a one-time event. A learning process is involved both at industry and supervisory level. The Expert Group expressed the view that, before attaining the stage of a mature market, a transition period was necessary during which the elements for establishing a competitive market would piece by piece come into place.

14. A first step towards a fully liberalized market as suggested by the Expert Group could be to establish by law the functioning rules of the insurance market especially prudential regulations in regards to capital, solvency, investment and reserving requirements, as well as the rules related to insurance contracts and consumer information. The law should also specify the role and powers of the supervisory authority as to secure a certain degree of independence of the supervisory-body. A differentiation in the regulations of non-life and long-term insurance operations are also usually set by law.

15. During the first phase of the transition the Expert Group recommended that rules especially those related to solvency requirements should be quite simple and evident. They could be simplified versions of those adopted by developed countries adapted to the local context. Capital requirements may be set at a rather high level as to avoid fragmentation of the market and entry of unsound operators. Accounting standards and reporting requirements should be worked out as to allow effective supervision of the sector. Entrants and form of foreign participation at this stage is a matter of policy decision. Capital and expertise could however be derived from such presence, security of foreign participant should however be a concern. Further liberalization could ensue as industry matures and consumer's understanding of insurance improves.

16. The present study first lists, in chapter I, the reasons for regulating and supervising insurance operation under a liberalized environment. It provides, in chapter II, some suggestions in regard to the supervisory process at the admission and licensing, ongoing monitoring and the rehabilitation and liquidation stage.

Chapter I
REASONS FOR REGULATING AND SUPERVISING THE INSURANCE INDUSTRY UNDER A LIBERALIZED ENVIRONMENT

A. Establishment of a sound and stable financial system

17. The development of stable and strong financial systems is crucial to sustaining long-term economic growth. To establish sound financial markets, one of the pillars of modern economies, stable political and economical environments are a prerequisite. Also, public confidence in the institutions that constitute the finance sector is of prime importance. Confidence can only be strengthened and maintained if the financial institutions deliver reliable and quality services. In this respect, the duty of governmental authorities is to secure the long-term stability of financial services providers through monitoring of their financial soundness and fair treatment of their customers. The maintenance of a "stable" market is viewed as of prime importance in a number of countries as for example in South-East Asian countries.[1]

B. Protection of insurance consumers

18. As mentioned in paragraph 11 of the introduction, under a liberalized market insolvencies of insurers are more likely to happen. Therefore supervisory systems geared to assess effectively the actual financial soundness of insurers, as well as mechanisms for intervention and for safeguarding interests of insurance consumers (guarantee funds) could be established.

19. Insurance represents a tool of prime importance in modern economies: it enables economic agents to reduce and better manage their risk exposures. The basic feature of an insurance contract is that the insured buys a future promise of payment contingent upon the occurrence of specified events. This means that the insured pays his consideration at the very beginning of the contract (payment of the premium), but before the insurer is called to perform "his part", the security profile of the insurer may have changed through time. The long-term reliability of an insurance provider must be beyond doubt.

20. The economic importance and the concern for protection of policy holders and third parties through time has led governmental authorities to enact regulations aimed at securing the long-term reliability of insurers. With the appearance in some countries (turn of the twentieth century) of compulsory classes of insurance (motor, liability, workmen's compensation), and because of the increasing level of complexity of insurance contracts, legislators started to concern themselves to an increasing extent with protecting the interest of the insurance consumer. This trend accelerated after the Second World War with the advent of "consumerism".

21. In developing countries, attitudes of policy-makers are shifting as a consequence of increased pressure for democratization. Until recently laws and regulations framing market conditions in a number of developing countries tended to be producer biased, but focus is changing towards giving greater consideration to consumer interests. This general trend is especially noticeable in attitudes regarding the insurance industry's treatment of policy holders, beneficiaries and third parties. Complaints from the public about unfair treatment on the part of insurance providers are considered with increased attention, as is demonstrated by the establishment in many countries of public complaints units within supervisory bodies or of ombudsmen's offices, as well as by enactment of regulations geared to speed up claim settlements. Today the protection of the public and its fair treatment is a major focus of most new insurance related legislations both in developing and developed countries.[2]

22. In a number of countries the concern for consumer protection has expanded the scope for insurance supervision to include other considerations such as the availability, affordability and quality of insurance services.

C. World trade liberalization

23. The opening up of developing countries' domestic insurance markets will undoubtedly change prevailing market conditions significantly (see also paragraphs 29 to 33). In this respect supervisory authorities have an important role to play. They may have to recommend related amendments to national insurance regulations. More specifically, they will have to ensure that the rules (i.e. cross- border trade, market access, establishment, national treatment, non-discrimination and transparency) ensuing from the implementation of the GATS (General Agreement on Trade in Services)[3] are implemented and respected.

24. The General Agreement on Trade in Services (GATS) specifically recognizes the need for protection of policy holders and for the stability of the financial markets:

> "[member countries] shall not be prevented from taking measures for prudential reasons, including for the protection of policy holders ... or to ensure the integrity and stability of the financial system"[4]

D. The institutional investors role of the insurance industry

25. Large funds constituting reserves to cover future obligations are under the custody of insurers. They are invested to produce returns, and the investment income improves insurer's overall profitability. They may also enable insurers under competitive pressure to charge lower rates than would be the case if based on pure underwriting experience. The management of these funds is thus very important to both the insurer and the policy holder. They may also play an important role in the development of national economies. Members of the Expert Group mentioned that the externalities (investments) produced by the insurance sector constituted a prime reason for supervision of the sector. In Chile, for example the insurance sector as a whole is the second largest institutional investor of the country. Appropriate regulations geared at channelling these funds towards certain areas of the economy may contribute to the overall economic growth of a country. This issue has often been raised in the context of developing countries where investment money is often scarce. However, it has been argued that imposition of rigid investment rules interferes with insurance companies ability to maintain the necessary levels of liquidity and security in their investment portfolios. Such provisions may also deprive companies of investment possibilities yielding higher returns. The role of governmental authorities is to find the right balance between the interests of policy holders and insurance companies and the need for investment funds for economic development.

E. Efficiency of insurance markets

26. The establishment of a dynamic insurance industry is in part the responsibility of legislators and supervisors. It is their role to set the enabling environment for the healthy development of the insurance industry and to deal with the incidence of market failures and imperfections. A well performing insurance industry is not only benefiting consumers but also the economy as a whole through better protection of the existing and future wealth of the country, the availability of more investments into the local economy and improvement of State finances through higher tax incomes

directly or indirectly derived from the increased performance of the insurance sector.

27. Regulators should ensure that markets develop towards optimal effectiveness and efficiency. the Expert Group expressed the view that paramount to market efficiency are the establishment of effective information systems. Market conditions should be transparent: consumers should be able to inform themselves on rates and conditions offered in the market, also to judge on the security of insurance providers. Supervisory offices could in this respect establish (as in Chile and other countries) information centres where such information would be available. Education of consumers is also relevant in improving market efficiency. External auditors and in some countries rating agencies provide also useful information on the financial soundness of insurance operators.

28. To achieve an optimum market structure (i.e. to have the ideal number and size of insurance companies) some trade-offs between security, concerns for competitiveness and product diversification may be required. In terms of products, also trade-offs are needed between product innovation and homogeneity. Thus, in countries where consumers have still little understanding of insurance, the concern for consumer protection and market efficiency could conflict, it is the responsibility of the regulator to establish adequate balance between freedom in product design and pricing and needs for fair information of consumers possibly trough some degree of prior approval and requirements for product homogeneity.

F. Foreign participation in the domestic market

29. As mentioned before foreign participation in the domestic market could be beneficial in terms of capital, expertise, economies of scale and better spread and mutualization of risks.

30. On the direct side of insurance business, foreign participation can take the form of cross-border trade, where the foreign insurer can offer products in the domestic market without being established in the market. This is rarely allowed, only some trade related products (cargo insurance) or very specific types of insurances not available in the market because of capacity constraints are permissible under cross-border transaction. In the specific case of the European Union, cross-border operations both in non-life and long-term insurance are allowed between member countries. Under the treaty establishing the "Conférence Interafricaine des Marchés d'Assurances" (CIMA) concluded among Francophone countries of West Africa such operations will also be permitted.

31. In regard to established trade, foreign participation could take the form of establishing a subsidiary, a branch or a partnership with a local investor (joint-venture) within the country. A subsidiary could be compared to any domestic company in that, it has to follow the same rules and requirements, and its capital and reserves are mostly situated in the country if the law so demands. However, in case of financial troubles the parent company might free itself from the subsidiary without contributing additional resources. In the case of a branch, reserves and capital might be out of the reach of local authorities and consumers interests might not be safeguarded. However, some members of the Expert Group mentioned that, in respect to branches, a parent company might support a branch in difficulties with its full financial strength. In this respect access to the home country regulator is of prime importance.

32. The particular form of foreign participation is a matter to be decided on a country-by-country basis with due consideration of the conditions prevailing in the respective domestic markets. In addition to general policy decisions on foreign participation in the domestic market,

the Expert Group emphasized that the main problem with such participation was the assessment of the financial security of the foreign entrant. How sound and experienced is the parent company is a highly relevant question. Questions also arise on the quality of, and communication with, the home country supervisor.

33. In regards to cross-border reinsurance operations, as for direct level entry, the prime concern relates to the security of reinsurance providers. A number of developing countries that have liberalized their reinsurance markets have introduced registers of admitted reinsurer and reinsurance brokers, transactions with non-admitted operators being handled on a case-by-case basis. Applications for being registered usually consist of submission of audited forms and details concerning capital (parent company) and financial solvency of the company.

Chapter II

SUPERVISION OF INSURANCE OPERATIONS

34. The countries that have given greatest consideration to competition, security of insurance companies and insurance consumer protection have introduced supervisory frameworks that include licensing and registration requirements, and to a varying degree monitoring of financial solvency (prudential regulations) and market conduct or practices of insurance services providers.

35. The supervisory philosophies vary from country to country. The developed countries with traditionally stringent supervisory regimes such as Germany, Japan and Switzerland still substantially supervise a wide range of activities. Authorities of these countries consider that supervisory bodies should not only check the solvency of insurance companies but also verify that an adequate balance exists between premiums and benefits under insurance contracts offered in their markets. Furthermore they ensure that policy forms comply with specific legal provisions for the fair treatment of policy holders.

36. Some other countries like the United Kingdom and the Netherlands, which traditionally have a "hands-off" approach to supervision, rely more on market forces. Governmental authorities of these countries concentrate on control of the financial situation (solvency) and allow competitive forces to determine market structure, rate setting, design of insurance contracts and other insurance business related matters. While monitoring processes were harmonized within the European Union countries, members of the Expert Group remarked that differences in emphasis still exist.

37. To decide on the intensity level and emphasis of supervision, developing countries establishing new legal frameworks should begin by assessing the degree of sophistication of the insurance consumer in their countries. If governmental authorities "think their citizens can look after themselves and are competent in economic matters. Organization of the market may primarily be left to insurance companies"[5]. If policy holders are considered inexperienced in insurance matters, they may require more protection, and extensive insurance supervision which would include some degree of product control may be the right answer. This approach was recommended by several members of the Expert Group.

38. A regulatory and supervisory framework should be established by law and should provide a definition of insurance operations, including which type of entity can provide insurance services and which insurance activities are to be monitored, as well as the powers and duties of the supervisory body. In most countries there is a separation between life and long-term insurance on the one hand and other classes of business on the other. The scope of supervision differs widely from country to country for reinsurance and intermediaries (brokers and agents). However, for the supervision of direct insurance operations, common features can be found among a number of countries that have liberalized their markets. In most countries insurance companies' activities are limited to insurance business. Companies may not, for example, hold majority stakes in businesses with other than insurance activities. Moreover, insurance operations can only be carried out by an authorized (licensed, registered) insurance concern.

39. Recently, however, in some countries, as a result of globalization, other financial services providers such as banks have been allowed to offer insurance products and insurers permitted to offer certain banking services. From a supervisory point of view, monitoring of entities that

supply different types of financial services poses difficulties in terms of consolidating supervision of the distinct activities. Recently a Tripartite Group of Securities, Insurance and Bank Regulators has completed work in this respect. The Group was in broad agreement about the need for maintaining the status of "solo" supervision of banks, insurance companies and securities firms forming part of a financial conglomerate. However, solo supervision needed to be complemented by a group-wide perspective, which can be given shape by a form of consolidated supervision. The Group recognized the difficulties of consolidated supervision, considering the different supervisory regimes operated by the regulators in charge of each sector. In the supervision of financial conglomerates, exchange of information between the different regulators was viewed as a key element by the Group. The enforcement of adequate transparency of legal and managerial conglomerate structure, the possibility of applying fit and proper tests to all responsible managers and the possibility of appointing a lead supervisor to bear responsibility for compilation of group-wide information were recommended by the Tripartite Group as initial steps towards securing solvency of such conglomerates.[6]

A Licensing and registration

1. Admission of companies

40. In all the countries that have liberalized their markets, an insurance firm, before starting its operations, has to register as a company, either limited by shares or by guarantee (mutuals and cooperatives). To be allowed to provide insurance services on a direct basis within a country, in the majority of cases the insurer is required to establish itself in the country.

41. Before commencing business the company is usually required to obtain a licence from a designated governmental department authorizing it to carry on one or several classes of insurance business. The licence may be renewable (each year) or be valid for an unlimited period of time given continuous compliance with set rules and regulations.

42. Application to obtain a licence usually includes the registered name and address of the company, copies of the articles of incorporation or association, details on the ownership of the company (shareholders) which is important to assess the stability and perenniality of the insurer. In regard to the management, many countries apply fit and proper tests (qualification, experience and criminal record) of the managers and directors. Screening of management fitness has been cited by the members of the Expert Group and in the UNCTAD survey as a very important responsibility of regulators[7]. Mismanagement has been cited as a cause of insolvencies (see paragraphs 49). The management team, looked at as a whole, should have the necessary balance of skills and experience to conduct successfully an insurance business[8].

43. To judge the overall financial strength of the planned operation, most countries demand a business plan/feasibility study mentioning *inter-alia*: the class or classes of business the company intends to carry out, target clients, proposed marketing channels (agent/broker network, direct marketing), projections of business volumes (in several scenarios based on a variety of sets of assumptions ranging from optimistic to pessimistic), technical basis for determining premium rates and reserves, investment policy, dividend policy and all other information deemed useful to assess the financial viability of the project. Complementary to the business plan, a forecast estimate of operating results during initial years may also be requested that details the financial expectations for the first few years of operation, including cash-flow statements, liquidity position and estimates of the financial means necessary to cover solvency margins and technical reserves. The operating plan should also contain details of the

company's intended reinsurance programme. As suggested by a member of the Expert Group, the business plan/feasibility study could even constitute the main basis for monitoring of an insurance company's operations.

44. Submission of an actuarial report containing an appraisal of the methods and principles used for premiums and reserving calculations and investment return projections used for the business plan. Such a report is of prime relevance for life companies. However, in the case of a non-life company, submission of such a report would also be advisable. The lack of available qualified actuaries in developing countries has been identified as one of the causes inhibiting the development of insurance. In this respect one can only stress the importance of undertaking a major effort to train sufficient numbers of persons in this crucial field.

45. To guarantee compliance with minimum capital requirements, companies are often required to deposit part or the whole of the paid-up capital with a designated entity (Central Bank, government body, etc.). These deposits will generally be considered to form part of the company's investments (regarding capital level requirements see paragraph 51). Where an insurance company is already established in other markets the necessary financial and other documents relating to operations in those markets should have to be submitted. The home-country supervisory authority should be approached in order to verify the company history. Communication between regulators in this respect was viewed as particularly important by the Expert Group. Only after the company has been incorporated and has obtained a licence can it begin to write insurance business.

2. Licensing of intermediaries

46. The way insurance products are marketed plays an important role in the development of the industry and of its credibility. As referred to in the introductory part, and highlighted by the Expert Group when liberalizing products the monitoring of intermediaries becomes more necessary. In many countries, intermediaries (agents and brokers) are required to obtain a license register with or from the insurance supervisory body. A prerequisite for licensing often involves an education and testing process to secure professional competence of future sellers of insurance products. This is certainly highly relevant in order to improve the image of the insurance industry and to combat fraud. Only agents and brokers with a sound knowledge of insurance and with high moral standing should be allowed to sell insurance. In most developing countries great efforts have still to be made to improve marketing of insurance and the monitoring of intermediaries may constitute a necessary first step in this respect.

B. Ongoing monitoring of operations

1. Monitoring of legal and statutory requirements

47. Supervisory bodies should see that all licensed (authorized) insurers are acting according to the latest laws, rules and regulations. The supervisory body should also check whether companies are operating in conformity with their latest approved articles of incorporation and business/operating plan, and, if the law requires verify that policy forms and rates actually in use conform with those filed by the respective company. With regard to directors and the management of insurance companies, any new nomination or replacement should conform with fit and proper criteria that might have been enacted.

2. Financial solvency (prudential regulations)

48. A primordial function of a supervisory body is to ensure that companies are financially sound and reliable, and this was regarded by the

Expert Group as the main function of supervisors in a liberalized environment. Regulations have to be complied with and it is the duty of the supervisory authority to ensure they are respected.

(a) Insolvencies

i) Causes of insolvencies

49. At the beginning of 1995 the UNCTAD Insurance Programme conducted a survey among insurance companies and institutions on their commercial expectations. Thirty-four companies from 28 developing countries replied. One of the questions asked related to the main causes of financial difficulties and insolvencies for both life insurance and the non-life sector in 1995. Under the top five causes cited for financial difficulties and insolvencies, problems common to both life and non-life insurance include over-capacity or over-competition and premium collection . Interestingly, the remaining three causes of difficulties in life insurance are related to the monitoring and management of companies: inadequate supervision by the regulatory authorities, fraud and mismanagement within the company and poor investment management. The three other anticipated causes in the non-life sector relate to rating, reserving and size of losses (catastrophic losses). All areas where effective supervision could prevent or at least dampen consequences of insolvencies.

ii) Prevention of insolvencies

50. Besides the financial analysis tools described later in this chapter, regulators should pay attention to certain signs that are hint of impending financial problems for an insurer. The following list, of which several factors were added by the Expert Group (marked*), while not exhaustive shows areas that have to be carefully monitored by supervisors.

"FACTORS THAT MAY SPELL DOOM":[9]

Management practices
- cash flow underwriting;
- rapid premium growth;
- deteriorating reserves;
- poor asset management, exposure to highly volatile investments;
- liquidation of certain assets: company pension fund, sale and lease back of office building;
- significant business changes
- poor products and products diversification;
- high operating expenses: lavish offices and entertaining expenses, excessive salaries;
- poor control over agents;*
- poor accounting, poor reporting;
- unsound use of derivative products.*

Relation with parent or affiliates:
- financially weak parent or other affiliate;
- no sound parent or no source of outside capital;
- unfair affiliated transactions: dividends, management contracts, reinsurance agreements, asset transfers;

Relations with reinsurers:
- slow payers, no payers,
- retrocessionnaire arrangements,*
- poor relations with reinsurance partners;

Relations with policyholders:
- poor service, claim settlement delays

(b) Financial solvency monitoring

i) Capital requirements

51. In most countries minimum capital requirements have been established. Insurance companies have to meet (or exceed) these requirements continuously during their life. These minimum requirements may vary with the size and type of business insurers are underwriting. In many developing countries there is now a realization of the importance of adequately capitalizing insurance undertakings, especially after disinvestment of the State from the sector. The adequate capitalization of

insurance companies was regarded as most important by the Expert Group. Private or privatized companies have to be self-reliant for their capital funding and solvency to preserve their long-term viability. Capital and reserving requirements have a bearing not only on solvency but also on the structure of markets: the higher the standards, the more concentrated a market is likely to be. The number of companies in a market is not a valid measurement of the level of competition in the market.[10] A market with a small number of financially sound companies of roughly equal size might have more competitive attributes than a market where a large number of unequally sized companies coexist with a few dominant concerns. Capital and reserving requirements and their effect on company size directly shape the retention capacity of markets. Companies with large levels of capital attain higher retentions and make less use of proportional reinsurance treaties.

ii) Solvency margin requirements

52. Many years ago, to be solvent an insurance company's total assets had to exceed its total liabilities. However, experience showed that for an insurance company to cover fluctuating and sometimes unexpected surges in its obligations, its total assets should include a certain surplus in excess of the minimum. The concept of a solvency margin, first introduced in 1946 by the United Kingdom, stipulated that total assets of a non-life company needed to exceed total liabilities by 20 per cent of premium written by the company. This 20 per cent margin is applied in many countries (for example, Australia, Malaysia, Singapore, Thailand). It is the basis for the slightly more complex requirements of the European Union. Members of the Expert Group commented that a number of other countries including developing countries (Central and Latin America and countries in transition of Eastern Europe) have introduced new solvency margin requirements, often simplified versions of European Union requirements in the course of liberalizing their markets.

European Union solvency margin requirements

53. The solvency requirements, still in force today, introduced under a Directive of 1973 stipulates that for <u>non-life insurers</u> the solvency margin must be equal to the higher of the following calculations:

premium basis: 18 per cent of gross premiums up to ecus 10 million's premium income and 16 per cent of the balance of gross premium income;

claim basis: 26 per cent of average gross claims of the three previous years up to ecus 7 millions, and 23 percent of the balance of average gross claims of the previous three years;

Premiums (and claims when appropriate) can be taken net of reinsurance, subject to a maximum reduction of 50 per cent for reinsurance sessions.[11]

For <u>life assurance companies</u> the required solvency-margin, as set by a directive of 1979, is equal to the sum of two calculations:

- The first result is 4 per cent of the mathematical reserves, with a maximum of 15 per cent being deducted for reinsurance cessions.

- The second result is 0.3 per cent of the capital at risk (the capital at risk being defined as the current excess of the sums assured over the mathematical reserve). For very short term maximum three year policies the percentage of capital at risk can be reduced to 0.1 per cent for policies and to 0.15 per cent for policies with a term up to five years.

A maximum deduction of 15 per cent being allowed for reinsurance cessions in the first calculation, or 50 per cent for the second calculation.[12]

54. The solvency margin calculation represents a powerful tool to regulate growth of premium volume, since to increase the solvency margin without injecting new capital requires profitable underwriting. "The primary value of the solvency regime can be seen as a mechanism for defining when the supervisory authority is allowed to intervene in the affairs of a company:"[13]

- if the company maintains its solvency margins, it is deemed financially sound;
- if the company's solvency margin is insufficient but above one third of the set minimum, the company has to submit a plan for restoration to a sound financial position to be approved by the competent supervisory authority (one third of the solvency margin goes into a guarantee fund);
- if the company's margin is lower than one third of the set minimum (insufficient for guarantee fund coverage), the supervisory authority requires the company to submit a short-term financing scheme and may also restrict or prohibit free disposal of the assets of the company.[14]

iii) Continuing capital and surplus requirements, cash-flow modelling, risk-based capital, financial ratios (North America).

55. In recent years, in Canada a compensation fund to protect policy holders from insolvencies of life insurers was established. "In order for a company's policy holders to be covered by the compensation fund, the company had to demonstrate a certain level of free assets (the Minimum Continuing Capital and Surplus Requirement (MCCSR)). The concept was later incorporated in a new insurance law and MCCSR was to apply to both life and general insurance companies".[15] Another significant concept developed by the actuarial profession and required by the supervisory authority for life insurer and soon for general insurance companies is the reporting of dynamic solvency testing (DST). These calculations are geared to provide a more dynamic view of an insurance company's financial condition. "DST is a forward-looking cash-flow analysis of the total financial situation of the company (including assets as well as liabilities, free assets as well as assets backing liabilities".[16] The analysis consists of a five years forward projection based on a central set of assumptions and testing for adverse deviations on a variety of assumptions. DST is now accepted as an important element in the financial control of life and general insurance companies in Canada. DST is a significant advance towards reporting the total financial conditions of the insurer, focusing on overall financial strength (regardless of the actual level of reserves) and on the ability to maintain financial soundness in the future in the face of possible adverse developments.

56. The United States of America insurance regulatory framework differs from that of other countries in that it is each individual state and not the Federal Government that supervises and regulates insurance operations within that state. "The states administer insurance regulations through state insurance departments. Each state tailors its insurance regulations to reflect its own interests. The National Association of Insurance Commissioners (NAIC) coordinates regulatory matters between the separate states, and recommends model insurance legislation, but has no power of enforcement."[17]

57. The NAIC has devised an "early warning test" that consists of a series of financial ratios computed annually for identifying troubled companies. This test includes ranges for each ratio considered passing or failing. Individual states differ as to how compliance with these ratios is enforced.

58. The NAIC IRIS ratios helps select problem companies and consist of two phases : a statistical phase during which key financial ratio results are generated and an analytical phase, during which annual statements and financial ratios are reviewed by experienced financial examiners. The system is intended to help state insurance departments in executing their statutory mandates to oversee the financial condition of insurance companies operating in their respective states. The IRIS ratios consist of twelve ratios for life companies and eleven ratios for non-life companies. Failing more than three ratios causes a review. Manuals on the IRIS system can be easily obtained from NAIC.[18]

59. In the United States a process of introducing a form of cash-flow modelling (DST) has begun. Also action by the NAIC to accelerate the intervention of regulators in the affairs of companies in cases of financial trouble has led to the development of the concept of risk-based capital (RBC). Risk Based Capital is the use by insurance companies of "asset and liability management" techniques which have been in use for some years in the banking sector and some other businesses. The introduction of RBC was needed because capital requirements were in many states inadequate (fixed in dollar amounts independently of the size of companies) and relating only to capital rather than total reserves. Risk based-capital (RBC) requires adjustment of free assets (capital and surplus) to the circumstances of individual companies.[19] RBC requirements define formulas for on-going capital levels based on risk. Formulas differ for life and non-life companies. They also define actions by the regulators at certain capital levels.

The life formula is based on :
- asset risk
- insurance risk
- interest risk
- business risk

The non-life formula is based on :
- asset risk
- credit risk
- indemnity risk
- off-balance sheet risk

The level of total adjusted capital of a company compared to RBC requirements will prompt action on the part of the regulators, ranging from no action, submission of a comprehensive financial plan, in depth examination by the regulator to outright control of the company by the regulator. Members of the Expert Group stated that the adoption of simplified version of RBC may in some countries provide a useful tool to adjust capital of insurance companies to adequate levels.

iv) Reserving requirements:

60. Technical reserves: Besides the legal and other reserves common to all commercial undertakings, insurance companies establish technical reserves that are calculated so as always to cover contractual commitments to policyholders and other beneficiaries. The supervisory authorities have a special responsibility for ensuring that all legal and regulatory provisions in this respect are complied with. Basically these reserves consist of the following:

For life insurers:

61. Mathematical reserves are reserves traditionally associated with life insurance and other long-term insurances (health insurance) in which the

risk often increases with time while the premium remains constant. These reserves are mandatory and in most countries regulations for mathematical reserves are more stringent than those for other kinds of technical reserves. This is because mathematical reserves contain large elements of savings, which are managed for policy holders by insurers acting as trustees for long periods of time. A number of countries have enacted laws or regulations that provide for the calculation of mathematical reserves by tested actuarial methods. Evaluation of these reserves by qualified actuaries is an essential element of any prudent regulatory and supervisory framework.

For non-life insurers:

62. Premium reserves (reserves for unexpired risk): Non-life insurance premiums are normally payable for annual periods beginning at any point during the financial year. Consequently, the risk may not have expired by the end of the financial year and a reserve must be set up to cover the "unearned" part of the premium for the period during which the insurer is still liable for any claim. The calculation of these reserves can be made contract by contract or by statistical methods based on experience and on groupings and sampling.

Claim Reserves : Claim reserves represent the most important liabilities of non-life insurers. These reserves are established to cover future claim payments. Reserves should be established to cover claims in the different stages of reporting to the insurer but unsettled at the date on which the balance sheet is drawn up. In a number of countries outstanding claim reserves are subdivided into outstanding claims reserves, reserves for claims incurred but not yet reported (IBNR), reported but not yet paid and partially paid.

Fluctuation reserves: May be established to cover fluctuations in loss ratios over future years, or for cyclical risks. Other reserves such as reserves for catastrophic or large risks may be set up for low frequency high exposure risks, particularly where the occurrence of loss may only once every 10, 20 or even once in more than 100 years.

Other reserves: In many countries reserves have to be established (either by life or non-life insurers), consisting mostly of an additional security to compensate for insufficiently precise evaluation of conventional technical reserves or variations in the value of their invested assets. In most countries, foreign companies have to comply with reserving requirements in the same manner as domestic companies. Often these reserves have to be established within the countries to cover risks underwritten locally.

v) Investment regulations

63. The Expert Group stressed that monitoring of investments, particularly those pertaining to technical reserves, was crucial to assessing the financial situation of an insurer. In most countries specific rules have been enacted regarding the investment of assets representing technical reserves, especially in respect of mathematical reserves. Beyond the general requirements for security and liquidity, most countries have imposed regulations mentioning the types of permitted investments and the maximum permitted holdings for technical reserves. The rationale of imposing strict investment regulations is to preserve long-term security for insurance beneficiaries. As far as the country's economic development policies are concerned, insurance funds should only be channelled to areas where both long-term stable returns and prospects for economic growth can clearly be determined. In countries undergoing privatization programme's insurers can play the role of institutional

investors and to a certain extent form part of the core and long-term shareholding in the newly privatized enterprises. This has been highlighted by several members of the Expert Group.

64. The basic investment principles for insurance funds (security, profitability, liquidity) must always be born in mind. This is particularly important when insurance markets are to be opened to foreign companies. The latter might derive a better return from investments made by their head office or from investing part of the funds of the branch office operating in the country in foreign markets bearing higher returns. For the ultimate benefit of the insurance consumer and the overall economy, distortions of the allocated efficiency of the investments of institutional investors should be avoided as much as possible. Also, as singled out by the Expert Group, amounts invested with a single borrower should be limited, in order to avoid difficulties where large holdings of stock may have to be liquidated and to soften the impact of failures of family-owned types of conglomerate. Concentration in one type of investment, for example real estate, can also have disastrous consequences, because the liquidity of such assets may not be assured as they are unlikely to be quickly realized.

65. In most developing countries, insurance companies are not allowed to invest abroad (following the principle of localization of investment). However, in a number of developing countries, a high proportion of the content of many insured risks is only replaceable by imported materials or services. Foreign currency reserves should be maintained to match underlying potential liabilities, especially in times of high inflation. Members of the Expert Group observed that in some countries investment vehicles adjusting to inflation levels were successfully used. In some countries, "investment provisions stipulate that the assets must be expressed in the same currency as the underwriting liabilities (matching assets). There are, however, exemptions in so far as there are limits for investments in certain categories."[20]

66. Investments in derivative products (contracts for differences as futures, options and swaps), as highlighted during the Expert Group, may pose new problems in regard to assessing security of such investments. Insurers may not be allowed to use such vehicles except to cover for fluctuations in values of underlying assets (hedging). Use of instruments that bear open liabilities should be in the view of the Expert Group discouraged unless prior approval of a set strategy from the supervisor is obtained.

vi) Valuation of assets

67. To be able to assess the solvency of an insurer correctly it is of the utmost importance that its assets, especially insurance funds and their underlying investments, are accurately valued. In this respect the most prudent accounting principles should be used. In most countries evaluations are at acquisition or book cost, and deductions for depreciation are allowed. In some countries, assets are valued either at acquisition cost or at market value, whichever of the two is the lower. A few countries allow the less conservative evaluation at market value; this can present difficulties in estimating the real value of assets on a reliable basis, and might only be feasible in countries with efficient investment markets. On the other hand it offers opportunities as it allows companies to utilize increases in their asset value to support the growth of underwriting volumes. For taxation purposes, hidden profits may also be released.

C. Supervision of business conduct (market conduct)

68. Besides monitoring financial solvency of insurance companies, supervision of insurance operations includes in many countries the control of how insurance providers conduct their business. Competition rules, transparency and information requirements form the core of market conduct regulations. Monitoring of rates and tariffs, marketing of insurance products, public complaints, consumer education and fraud fall under this aspect of supervision.

i) Prior approval v.s. file and use

69. The rates and terms and conditions of insurance policies in many developing countries require prior approval. Recently, as was reported during the Expert Group meeting, and in line with liberalization policies, there has been a noticeable shift towards a file and use system particularly in the Latin American countries. Results from a questionnaire[21] have shown that approval of conditions and rates does not represent a high priority for surveyed supervisory bodies. However, some members of the Expert Group expressed the view that prior approval could more effectively protect the interest of "uninformed" consumers particularly during transition phase to a liberalized market. Nevertheless, the members of the Expert Group reported that considerable resources on the side of supervisory authorities may have to be engaged to monitor the mass of information necessary to make authoritative decisions regarding rates and policy forms. In small markets with few companies and few products on offer, this could be a manageable procedure. Prior approval diminishes the freedom of action and responsibility of managers of insurance companies.

ii) Underwriting, rating and tariffs

70. In many countries, supervisory authorities have the right to require information about the underwriting practices and rate structures in use by an insurance company. Underwriting being the process by which an insurer evaluates and accordingly selects the risks it will decide to cover. Underwriting decisions directly influence the profitability and financial soundness of an insurer. From a supervisory point of view, knowledge and understanding of the underwriting practices of a company was viewed by the Expert Group of prime importance to assess the soundness of the insurer. Also, supervisors should carefully search wether a company unfairly discriminates certain categories of consumers. With regard to rates, in many countries insurers have to file their rating table for approval with the regulatory body before its implementation, while some authorities require only submission of new rates for information. The control and setting of rates by the supervisory authority may theoretically represent the ultimate consumer protection, as all elements of an insurance operation are in the hands of the authority. It should apply all prudent measures possible so as to ensure the reliability of the insurer in question. A weakness of this system is that State regulators may be tempted to bow to political pressure for cheap insurance prices at the expense of ensuring that insurers maintain appropriate solvency and security. The concept of fixing rates within certain ceilings to allow for adequate coverage of the underlying risk and for a small profit for the insurance company is very often applied to compulsory mass products or personal lines, such as motor insurance. The perception is that for these types of product authorities have to secure affordability, availability and fair treatment of insurance consumers. In the case of commercial lines, the insurance buyer is deemed more sophisticated and able to better protect its interests. Often tariffs are set by "committees" within national associations of insurers together with the supervisory authority. Since the determination of premium rates calls for the utilization of a large amount of statistical and economic data, an association of insurers will possess broader experience than a single insurer. Coordinated price fixing certainly hampers competition and

product innovation, but for young markets, and in the view of the Expert Group, a period of price stability may give consumers a better understanding of the intricacy of insurance products.

71. The law of large numbers enables insurance companies to improve the predictability of losses by pooling similar independent risks. One of the consequences is that large-sized insurers may gain a competitive edge if they are able to underwrite large numbers of homogeneous risks on a larger geographical spread. However, insurance technology has now advanced and methods of rating, based on other principles, such as statistical inference and portfolio management theory, which do not need large numbers for their application, allow niche players to operate successfully. As a result, medium-sized companies may also be profitable, provide good services and offer tailor-made products. Prices of mass products can be undercut through risk segmentation, marketing, direct writing, multi-peril writing, globalization, etc., while sound solvency requirements are still respected.

72. Regulators may have difficulty in differentiating between a competitive edge and commercial malpractice (dumping practices). Further difficulties arise with the problems of cross-subsidization between business lines, when losses on one product are covered by in-built surpluses of other lines. The losses in motor insurance, which are often covered by surpluses in fire business are a typical example. This practice represents unfair treatment of fire policy holders. When greater competition is allowed or markets are opened to foreign entities domestic companies may no longer be able to cross subsidize because of competitive pressures, with the result that certain "protected" lines might experience dramatic rate increases while in profit making lines heavy rate competition might occur. The integration of expected returns on investment into rating calculations poses further problems, especially in countries where investment markets (stock exchange, bond markets, real estate, money market, etc.) are still very fragile and volatile.

73. The supervisory body should decide which kind of product features should be promoted in view of the best interests of the consumer: security, price competitiveness, diversity, tailor-made products, quality of services. Authorities have to adapt their insurance legislation to the needs of their insurance consumers, an ongoing process since consumer interests are shifting.

ii) Distribution of insurance services

1. <u>The insurance contract</u>

74. In many countries insurers are required to submit the documents that form the basis of the contractual relationship with policy holders to the supervisory authority, in particular pro forma policies, policy conditions and proposal forms. Approval of these documents is often a prerequisite for granting a licence to operate. The supervisory authority should ensure that the contractual relationships have a legal basis that is not prejudicial to the interests of the insured, since the insured does not generally participate in the negotiations regarding policy clauses. By ensuring the correctness of these clauses the supervisory authorities fulfil one of their primary functions. A member of the Expert Group reported to the UNCTAD secretariat certain clauses that are required to appear in life insurance policies marketed in her country namely: Incontestability, under which the insurer after a certain period can no more contest statements made by applicants; Nonforfeiture, which protects the cash value of the policy and grace period, under which an insured is given a grace period after the premium is due to pay the premium and during which the policy cannot lapse. In order for consumers to make an informed

decision, a degree of comparability between contracts on offer in the market may be maintained during transition to a fully liberalized market.

2. Marketing, intermediaries and premium collection

75. Marketing of insurance product should be attentively monitored so as to preserve information fairness towards consumers. Advertisements should not be misleading, past experience should not be used to extrapolate future results. Products should not misrepresent benefits, often insurers tend to differentiate their products from competitors by incorrectly describing or overstating advantages and benefits.

76. Distribution of insurance in most countries is through intermediaries (agents and brokers) who are actually selling the insurance products. Consumers decisions are mainly based on their relations with intermediaries since they mostly are the only source of information on insurance for the public. The Expert Group confirmed that insurance had a clear image problem in many developing countries, and emphasized that improving the professionalism of intermediaries should be a high priority. As already mentioned (paragraph 46), sellers of insurance should obtain a license before commencing business. Testing of their competence in each of the lines they are allowed to market may be mandatory. Supervisors could monitor this testing process. It could be conducted by companies, insurance associations, insurance institutes or directly monitored by the supervisory body. Accounts of intermediaries could also be regularly filed with the regulator.

77. A clear set of sanctions including the withdrawal of the license could be devised by supervisors for misbehaviour of intermediaries. If complaints are received by authorities, their conduct could be investigated. The three main problem areas encountered with agents and brokers are the following :

- misrepresentation of benefits of a policy in order to get commissions. A common practice, called "churning", of producers (especially in regard to time contracts (life insurance) consists of trying to convince consumers to replace "good policies" by new ones with no, or minor additional benefits. This is because intermediaries usually receive only a one-time commission at inception of a life insurance contract or are rewarded for performance;

- premiums are not paid to the insurer or forwarded with delay causing serious cash-flow problems for insurers;

- benefits (claim settlements) are kept by agents and not delivered to consumers.

78. It was conveyed to the UNCTAD secretariat that in some countries only 30% to 40% of premiums written reach companies. While this is not all due to malpractice by intermediaries, premium collection is a prime area of concern with regard to the financial stability of companies. One of the characteristics of a sound insurer, which was pointed out by the Expert Group, is its ability to control tightly its producer network. Delay in the payment of premiums on the part of policy holders has led a number of regulators to enact a "no premium, no cover" rule. This had a beneficial impact on the cash-flow position and financial stability of companies in those markets.

79. Regarding claim payments the Expert Group punctuated the importance for insurance companies to settle due claims within a reasonable time and with a fair compensation. In a number of developing countries, claim payments are too often unduly delayed. This type of practice undermines the purpose for taking out insurance. The general public in those countries tends to regard insurance as an additional form of taxation and is not aware of the real benefits insurance can bring.

iii) Insurance fraud

80. Until recently insurance fraud has been perceived from the supervisory point of view as a minor problem. However, under an UNCTAD survey[22], company fraud and mismanagement was cited as the third possible cause of insolvencies for life-insurers. In the context of globalization of markets, members of the Expert Group have observed an increase in fraudulent activities (including money laundering) have been noticed in relation to insurance operations. Combating fraud has become an increasing problem for supervisors. As remarked during the Expert Group, unless communication networks are established between supervisory authorities, it will be very difficult to keep a check on fraud of an international character. Developing countries and off-shore centres are not spared by the phenomenon.

81. On a domestic level, the following frauds against insurance consumers may be mentioned:[23]

- intentionally bankrupting of insurance companies
- diverting premiums from claim reserves
- outright personal gains using insurance money
- outright theft of premiums

iv) Public complaints

82. In a number of countries formal offices have been established either within the supervisory authority or set up as ombudsmen's offices to respond to insurance customers' complaints. Their purpose is to streamline administrative procedures and sometimes to serve as an alternative to judiciary proceedings. The Expert Group members have recognized that for supervisors the monitoring of complaints represented a very useful source of information concerning the reliability of companies and for holding insurers responsible for their offered services. In most cases, companies in difficulty delay claim payments or settle claims in an unfair manner. To resolve complaints, supervisors should facilitate communication between insurers and complaining customers. They should make sure that companies have complied with the law, have responded promptly and fairly and should refer to insurers any possible contract language problem. A tracking system of complaints could be kept and regulators should verify how companies involved compare to the industry average complaint ratio. Deviations from this average should be investigated.[24]

v) Consumer education

83. The Expert Group deemed that the development of markets was in direct correlation to the building up of consumer awareness and understanding of insurance, and that to improve market efficiency consumer education was highly necessary. In several countries, supervisory authorities have as part of their mission to contribute to the education of consumers in matters related to insurance. The development of the industry is very much dependent on awareness-building among the public. Also, protection of insurance consumers interests can be improved on a preventative basis through better information. Typically, supervisory offices issue brochures on the role of insurance, the rights and remedies of policy holders and

description of products and services. Setting up of an information centre, as was mentioned by one of the Expert Group members, could be envisaged where relevant information would be easily accessible by the public and assistance by telephone may also be provided. Regulators should keep a neutral position in their advice in order not to favour a particular insurance provider.

D. Monitoring of portfolio transfers, rehabilitations and liquidations

i) Transfer of portfolios, mergers and acquisitions

84. The insurance regulations of many countries provide for the possibility of transferring the portfolios of one company to another insurer subject to certain conditions. Portfolio transfers may have to be authorized by the supervisory authority and in most cases acceptance by a certain percentage of policyholders is sought. Some members of the expert Group observed that it might, however, pose practical difficulties. Members of the Expert Group suggested that actuarial reports might also be required. In any case, policy holders should be informed when a transfer is proposed (through individual notices or the official gazette and relevant newspapers). Supervisory bodies should ensure that the portfolio transfer does not damage the interests of policy holders.

ii) Rehabilitation and liquidation

85. When a company ceases operating and has to be liquidated it has always a serious impact on the stability of the market as a whole. Preventive measures on the part of the supervisory authority can pre-empt troubles to the market. If the financial analysis or an in-depth examination of a company reveals important financial difficulties, depending on the degree of seriousness of the problems supervisors may have to intervene in the company's operations. As a first step the regulator might have to monitor closely daily activities with the management still in charge. At this stage, actions may include freezing of assets, reduction of premium volumes and of expenses, elimination of unprofitable lines of business, focusing on products where the company has expertise, realignment of reinsurance programmes, improvement of financial reporting and changing or reducing personnel.

86. If the problems are far more serious, the supervisor may have to take over direct control of the company (known as "administration rehabilitation process"). Policy holders and the public are informed of the company's situation, the management is removed and major changes to the company's operation have to be carried out to try to salvage it.

87. If it is determined usually after a judicial proceeding that liquidation is unavoidable, a liquidator is generally appointed who, in close coordination with the supervisory authority, is responsible for the proper winding up of the business. Claim processing and protection of policy holders interest is a major component of a liquidation plan. In most countries policy holders (especially life policy holders) have preferential rights if the insurance company becomes insolvent, which give them priority over other creditors.

iii) Guarantee funds

88. In some countries prefunded "guarantee funds" have been established by minimal levies on premiums or insurance operations as an additional protection for policy holders and other beneficiaries in the event of failure of an insurance concern. This type of guarantee fund was seen as the most appropriate by the Expert Group for developing countries

considering the establishment of such a scheme. The utilization of funds under a guarantee scheme is very often the prerogative of the supervisory body while their administration may be handled by another governmental department or by the national insurance association. Guarantee systems can also consist of post funded plans, industry bailouts and government backed bailouts. Guarantee funds should reflect the type of business for which they were conceived, life and non-life insurance being very different in this respect. In the context of developing countries establishment of a preassessment system may more easily circumvent resistance of the industry. In case of a post-funded scheme companies might be unwilling to pay for the damages created by a perceived poorly managed competitors. All schemes are geared to smooth the impact of a company failure on insurance consumers and on the stability of the market. However, one should not lose of sight that in all cases it is the public who will finally carry the burden of insolvencies and cost benefits analysis of establishing such scheme should be carefully conducted. The Expert Group remarked that no guarantee scheme provided a reliable alternative to effective supervision.

E. Reinsurance

89. While some insurers in developing countries do accept reinsurance business from abroad, the great majority of developing countries are net buyers of reinsurance. In a number of countries reinsurance contracts, especially those entered into by insurers also transacting direct business, are subject to supervision because an unsound reinsurance policy might upset a company's stability and endanger its direct portfolio. The monitoring of these reinsurance programs is often less strict than supervision of direct business and in many cases simply requires copies of treaties and other contractual documents and the list of reinsurers to be submitted to the supervisory authority. Submission of these documents is not aimed at evaluating the fairness of reinsurance contracts but rather at ensuring observance of technical and financial requirements. Monitoring of the security of reinsurance providers was seen by the Expert Group as most important. "The task of monitoring the security of reinsurers falls principally upon ceding companies, since it is up to them to choose their reinsurers. Such security analysis is, however, not always conclusive, this is either because of lack of necessary data to serve as a basis for assessment or because of the inability of the ceding company to use the available data to obtain an appropriate picture of the reinsurers"[25]. In this respect, insurance supervisory authorities can play a role in "exercising some control over the choice of reinsurers by the ceding companies to ensure the good security of chosen reinsurers. However, such control will be ineffective if the supervisory authority itself lacks sufficient knowledge of the international reinsurance markets and international reinsurance practice"[26].

90. In some countries, the supervisory authorities require that reinsurance treaties concluded by domestically established concerns contain clauses providing that technical reserves must be left at the disposal of the ceding company (deposits). This often applies to reinsurance treaties concluded with foreign concerns. The main purpose of such a requirement is to ensure that the local insurer has immediate funds from reinsurers to settle claims as they arise, and to provide to the ceding company an additional degree of security as, in the event of insolvency on the part of the reinsurer, such deposits can serve to discharge the liabilities of the reinsurer. International reinsurers have drawn attention to the fact that the return rates on deposits held by ceding companies are often far lower than rates that would actually be earned by them on these funds and this practice of requiring deposits actually increases the cost of reinsurance for the developing country.

NOTES

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4. The General Agreement on Trade in Services (GATS) Annex on Financial Services, Article 2(a).

5. August Angerer, "Insurance supervision in OECD member countries", Policy Issues in Insurance, OECD publication, (Paris, 1993), pp 68 - 69

6. Tom de Swaan, "The Supervisory Overall Approach to Financial Conglomerates", International Association of Insurance Supervisors (IAIS) Conference, St. Louis, June 1995.

7. See, UNCTAD/SDD/INS/10, op. cit.

8. Hosney T. El Zanfaly, "Monitoring of Legal and Statutory Requirements". Seminar on Supervision of Insurance Operations, Cairo, 1995. p.2

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11. See Angerer, op. cit. p.32, and Guy Simonet, "Une approche de la solvabilité de l'assureur dans les pays de la C.E.E.", Policy Issues in Insurance, OECD publications, (Paris, 1993), p.174.

12. C.D. Daykin, "Changes in Regulatory Controls in Insurance for Financial Stability", 9th Third World Insurance Congress (TWIC), Cairo 1994, pp.3-4.

13. Ibid, p.4.

14. See, Simonet, op. cit., p.176.

15. See, Daykin, op. cit., p.13.

16. Ibid, p.14.

17. Harold D. Skipper, "Insurer solvency regulation in the United States", Policy Issues in Insurance, OECD publications (Paris 1993), p.75.

18. National Association of Insurance Commissioners, 120 West 12th Street, Kansas City, Missouri 64105, United States of America.

19. See, Daykin, op. cit., p.16

20. See, Angerer, op. cit., p.37.

21. See, UNCTAD/SDD/INS/10, op. cit.

22. Ibid

23. See, Hank, op. cit.

24. Ibid

25. "Reinsurance Security" study by the UNCTAD secretariat (TD/B/C.3/221/Supp.1), January 1987, pp. 34-35

26. Ibid., p.35